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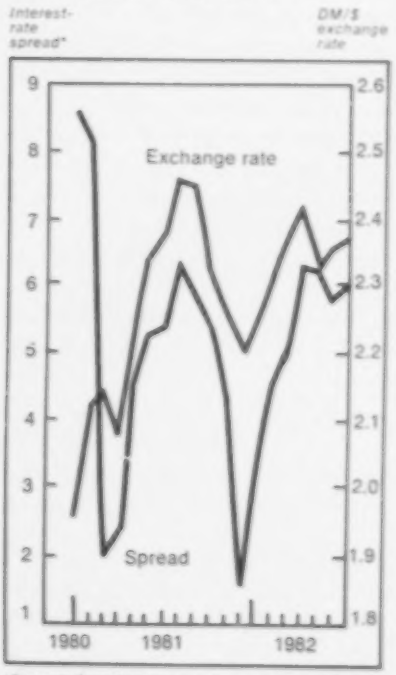
Has Germany Really Achieved Policy Independence?

Against the background of a policy of monetary ease that was initiated last fall, a new attitude has recently emerged in Germany. After acting to reduce domestic interest rates on four separate occasions, German monetary authorities have announced that Germany has gained a "measure of independence, . . . uncoupling, to a very great extent" interest rates in Germany from those in the United States. In light of the European criticism of high U.S. interest rates voiced at the economic summit in Versailles, this new attitude of German independence is truly enigmatic. Has Germany, indeed, succeeded in reducing domestic interest rates without undermining the mark against the dollar? Or, alternatively, are the Germans merely attempting to provide assurance to the market, anticipating potential criticism of their stimulative policies?

Relative interest rates and the value of the dollar



*3-month Euro $ rate minus 3-month Euro DM rates

The German authorities began relaxing their stance on monetary policy last October, after the dollar had weakened from its summer high. During the following five months, as official interest rates in Germany were lowered further and spreads favoring the dollar widened, the mark weakened—at times, substantially. For example, during the first quarter of 1982, the mark, at one point, had depreciated almost 10% against the dollar, relative to its position when the German easing began. From this perspective, it is difficult to perceive the German independence. It becomes even more difficult in light of the fact that U.S. interest rates, on average, have not risen since the German reflationary policy began. In fact, the widening of Eurocurrency spreads, favoring the dollar, reflects the expansionary German policy.

As long as financial capital is freely mobile, the economics of international capital markets precludes independence of a country's domestic interest-rate policy. However, to say that monetary policies are not independent is *not* to say that exchange rates always follow interest-rate differentials. A major shift in market sentiment regarding relative inflation differentials can cause a realignment of exchange rates in relation to relative market interest-rate spreads. As an example, while interest differentials favoring the dollar have shrunk significantly since 1980, the dollar has appreciated over 20% against the mark. The key seems to be a greater improvement in U.S. inflation compared with Germany's.

Taking all of this into account, the statements of German independence are merely attempts to assure the market that the recent expansionary monetary policy will not further confirm the assessment of a weaker mark relative to the dollar over the long run.

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French recovery fading; current-account and budget deficits widening.

France's latest economic data have brought only bad news to the French authorities. Despite attempts to reflate the economy, the recovery appears to be running out of steam. Investment remains severely depressed and foreign demand shows no sign of picking up. It now seems unlikely that the government can achieve its target of 3% real GDP growth this year. Moreover, inflation remains around 14% and the current-account deficit continues to widen. The April trade gap of FF 10.1 billion was the largest deficit for a single month since 1968. The cumulative deficit for the first four months amounts to FF 26 billion compared with FF 14 billion in the corresponding period of last year. In addition, the projected deficits of the central government's own finances and of the Social Security Fund are causing disquiet. There are some grounds for believing that these problems will now lead the authorities to tone down their expansionary aims. In the more immediate future, a downward adjustment of franc intervention limits within the European Monetary System remains in the cards. Speculation on this remains intense as reflected by the high level of Eurofranc interest rates.

Denmark set for recovery; devaluation pressures unlikely to subside.

The Danish economy appears set for recovery, with real growth of at least 2% expected this year. Faster growth will boost government revenues and this year's budget deficit is projected to be some Dkr 51 billion—just under 11% of GDP instead of the 16% figure that had been widely forecast. Inflation, however, remains high, with consumer prices up 11.3% in the year to March and wholesale prices up 10.7% in the year to April. This has led to continuing fears of another kroner devaluation. These fears have some basis, in that with wages set to rise about 12% this year, Danish export competitiveness will come under increasing pressure as the year progresses. In addition, it has not been forgotten that Denmark asked for a 7% devaluation in February but had to agree to only 3%. This would seem to suggest that the remaining 4% drop will not be long coming. However, the government has indicated that it wishes to hold to today's exchange rate at least until the summer is over.

Swedish economy beset with problems; further policy changes needed.

The Swedish economy is improving but still has a long way to go. The government has made a number of policy changes aimed at correcting the country's economic problems, including: a cut in the growth of public spending, tax reforms designed to stimulate work incentives, measures to boost saving, moderation of wage increases, and a reduction in subsidies to industries. Unfortunately, however, these policies have not yet had their full effect. Industrial production has remained weak, investment has fallen, the budget deficit has continued to rise, and the current-account deficit has not improved. GDP is expected to grow by only a little over 1% this year. Some progress is likely in reducing the rate of inflation. Consumer prices are expected to increase less than 9% on average—the first single digit inflation rate since 1979. Nevertheless, it appears likely that further policy changes in the direction of those already enacted will still be needed.

Ecuador devalues sucre in an effort to improve trade balance.

Bowing to the pressure of a sharp decline in international reserves, Ecuadorean officials devalued the sucre on May 13—down to 33 per U.S. dollar from its previous level of 25. This was the first official devaluation since 1970, although a multiple exchange rate system had been set up in March in an attempt to stave off a full devaluation. But lagging oil exports and high import demand left the authorities with little choice. Last month's action requires all imports, exports, and new loans to be transacted at the new rate. If holders of existing private-sector foreign debt agree to refinance, however, they may obtain dollars at a more favorable rate. Beyond these official rates, a parallel free market—fluctuating at around 43-46 sucres—exists for tourist and other transactions. The Ecuadorean government is currently preparing a stabilization plan to support the devaluation And although authorities expect some initial slowdown in economic growth as a result of the move, they also hope to see an improvement in foreign trade from the parity change.

Improvement in government finances key to Peruvian adjustment program.

Peru is pursuing an economic stabilization program for which it hopes to obtain the financial backing of the International Monetary Fund. In March, the authorities reached an agreement on a three-year Extended Fund Facility arrangement for SDR 650 million, subject to IMF Board approval in June. The objectives of the program are to restore balance-of-payments equilibrium, lower inflation, and boost economic growth rates. Critical to the adjustment effort is a significant improvement of government financial operations. Peruvian officials hope to reduce the public-sector deficit to the equivalent of 4.2% of GDP this year from 7.8% in 1981. Whether this goal will be realized, however, depends on the government's willingness to take several potentially controversial policy steps, including: the elimination of most of the remaining subsidies for basic foods, frequent upward adjustments of petroleum prices and public-utility tariffs, the introduction of some additional tax measures, and, most important, a large reduction of expenditures, particularly investment outlays.

Higher interest rates bring surge of capital into Australia.

Australia's external capital inflows, which had slowed down substantially as last year's resources boom subsided, are now reviving in response to a sharp increase in interest rates. Rates on 3-6-month certificates of deposit, for example, have risen more than 500 basis points since the beginning of the year. Tight monetary control, instituted by the government out of concern for inflation and wage pressures, was the principal cause of the rate hike. Since world market rates have generally declined during this period, international interest-rate differentials have turned increasingly in Australia's favor. As a result, capital inflows have surged, reaching a record level of A$2 billion in April. For the moment, the renewed inflow of capital relieves the government from immediately having to decide on some sort of trade or exchange rate policy changes to stem a widening current-account deficit. However, the benefits on the real economy from these interest-rate sensitive financial flows will be markedly smaller than last year's resource-induced investment funds.

Continued recession forces Philippine government to rein in budget.

The Philippine government is under pressure to take steps to contain its 1982 budget deficit in light of the continued slump in both domestic and international economic activity. Last year, despite expenditure cuts, the budget deficit rose to an estimated 11.9 billion pesos, or 3.9% of GNP—some P2.8 billion higher than officials had forecast. This was a substantial increase over 1980's P3.4 billion deficit which equaled only 1.3% of GNP. The primary reason for this poorer-than-expected performance was a shortfall in revenue resulting from the depressed state of the economy. In 1982, the deficit is projected to narrow to P10.5 billion or some 3% of GNP, but the danger of another revenue shortfall and a significantly wider budget gap still exists. As a result, the government recently announced plans to cut expenditures by P5 billion or almost 10%. Whether this action will be sufficient is not clear. However, it is certainly a step in the right direction to help contain both the budget and balance-of-payments deficits in the face of the adverse external circumstances.

Ivory Coast economy stagnant; sights lowered for oil output.

Continued restrictive fiscal and monetary policy and an outflow of capital induced by unfavorable interest-rate differentials have brought economic stagnation to the Ivory Coast. Real GDP growth slowed to 1.4% in 1981 and no growth is foreseen this year. External accounts showed some improvement over the record deficits of 1980 as dampened aggregate demand led to lower imports. Still, the 1981 current-account deficit is estimated to have been close to $1.5 billion and a similar shortfall is projected for 1982. Consequently, further substantial borrowings will be required on top of an outstanding foreign debt that is already over $5 billion. Debt-service obligations are expected to claim some 35% of foreign exchange earnings this year. In addition, previous forecasts of expansive petroleum exports by the mid-1980s have had to be substantially revised. Oil self-sufficiency is still projected for 1983, but exports are now expected to be modest, at least over the medium term.

Fed Policy: The Old Versus the New

The recent declines in money market rates, in response to the slowdown in money growth since mid-April, once again illustrate the importance of the behavior of money in determining the course of money market rates in the short run. This relationship has been observed since the early 1970s, when the Federal Reserve switched to a policy strategy of targeting monetary aggregates. But it has become more pronounced since October 1979, when the Fed shifted the focus of its operating tactics from the federal funds rate to bank reserves. It is somewhat surprising, however, that, on average, the timing of the reaction of the funds rate to deviations of money growth from target since the Fed's tactical change has been quite similar to that of the earlier period, with one notable exception. What is disconcertingly different between the two periods is that it is now much more difficult to discern not only when the short-run policy stance of the Fed has changed, but also, the implications of any such change for the behavior of the funds rate.

Prior to October 1979, the operating target of Fed policy was a narrow trading range for the federal funds rate, and open-market operations were designed to keep the funds rate within this range. Whenever money growth deviated from target, the Fed attempted to bring it back into line by adjusting its funds-rate target. Disillusion with the ability of the Fed to control money growth via this tack was at least one—although by no means the only—force leading to the October 1979 shift to using bank reserves as the principal target variable.

While the Fed's current approach to monetary control through managing bank reserves is allegedly "supply-oriented," in reality, the effect of policy action on the federal funds market is still a major link to money growth. The reason for this is that under the new operating tactics, the Fed controls not total reserves, but "non-borrowed" reserves, that is, total reserves less reserves supplied through discount-window lending. This is mainly because the Fed's lagged-reserve accounting system means that required reserves are determined each week by the level of reservable deposits held two weeks earlier. Under the new tactics, if money growth is greater than desired, banks' demand for reserves rises as a result of the increase in reserves required to support the higher level of deposit growth. If the non-borrowed reserve target remains unchanged, then the funds rate is bid up relative to the discount rate until enough banks are "driven" to the discount window. The subsequent rise in the funds rate is then

Asia and Oceania — Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE OF
			6 months ending	12-month change	in billions of dollars	per capita	latest data
Asia	Bangladesh	Real growth expected to be slightly negative for fiscal year ending June 30.	Dec.	— 6%	12.0*	133	April
	Burma	Real growth estimated at 6%-6.5% in fiscal year ended March 31.	Jan.	— 3%	5.3**	150	April
	China, People's Republic	Strong recovery taking place in heavy industry.	Dec.	+ 3%	242.2†	246	Dec.
	Hong Kong	Government revenue and surplus for fiscal 1981-82 revised downward.	Oct.	+23%	24.3	4,710	n. a.
	India	Restrictions on industrial investment relaxed to spur production and exports.	Jan.	—22%	161.4**	236	Jan.
	Indonesia	Victory by ruling Golkar party suggests no changes in economic policy likely.	Sept.	— 9%	77.5	500	March
	Japan	New period of inventory adjustment underway, with slowdown in exports.	March	+ 2%	1,126.8	9,559	April
	Korea	Government extends tax and credit assistance to business.	March	+ 8%	63.4	1,630	April
	Malaysia	Development plan reassessment likely to result in scaling back, postponement of projects.	Dec.	—14%	24.2	1,742	Feb.
	Nepal	Real growth near 3% expected for fiscal year ending June 30.	March	+ 9%	2.3*	165	Jan.
	Pakistan	Steps to restructure tax system and further liberalize imports expected to be announced soon.	March	—27%	30.6*	365	April
	Philippines	Delay in world recovery depressing economic activity.	Dec.	—10%	39.7	801	April
	Singapore	Economy grew at 7.3% annual rate in first quarter of 1982.	Feb.	+ 3%	11.6	4,780	Jan.
	Sri Lanka	Rice and tea crops hit hard by drought.	Dec.	+ 3%	4.3	288	Jan.
	Taiwan	Investment tax credit extended another year.	Nov.	+19%	45.5	2,530	Dec.
	Thailand	Revenue shortfall necessitates 4 billion baht reduction in government spending.	Jan.	+ 6%	36.1	760	April
Oceania	Australia	Arbitration Commission rejects unions' national wage claims; unemployment stands at 6.3%.	March	— 6%	156.0	10,500	April
	New Zealand	Financing for $1.2 billion synfuel project finalized.	Feb.	+ 1%	24.4**	7,858	March

							BALANCE OF
							reserves (less gold) in million $	12-month change	months of imports covered	use of cred lions o
Asia	Bangladesh						158	— 39%	0.7	37
	Burma						187	— 36%	7.1	5
	China, People's Republic						5,048	+ 98%	3.0	50
	Hong Kong						—	—	—	—
	India						4,771	— 32%	4.6	1,31
	Indonesia						5,235	— 15%	5.1	
	Japan						26,845	0	2.2	
	Korea						3,037	+ 3%	1.4	1,31
	Malaysia						3,635	— 14%	3.6	21
	Nepal						202	+ 14%	6.5	1
	Pakistan						741	— 32%	1.7	91
	Philippines						1,964	— 22%	2.7	91
	Singapore						7,612	+ 15%	3.3	
	Sri Lanka						380	+ 46%	2.7	38
	Taiwan						7,235	+228%	3.5	
	Thailand						1,490	+ 17%	2.0	67
Oceania	Australia						2,680	+ 2%	1.2	
	New Zealand						329	— 21%	0.7	2

*Fiscal 1980-81 **Fiscal 1981-82 †1980

supposed to depress the demand for money, and thus bring money back into the targeted range–just as it was under the old strategy.

Consequently, the effect on the federal funds rate of deviations of money growth from target is similar: Under the old strategy the explicit funds-rate target was changed; and under the new strategy, changes in the demand for reserves–relative to the supply of nonborrowed reserves–affect the funds rate relative to the discount rate.

Indeed, empirical research supports this assertion. When percentage changes in the funds rate were compared with deviations of money growth from target, the results for the pre-October 1979 period and the post-October 1979 period were quite similar in qualitative terms. One notable exception was that money growth had a much weaker influence on the funds rate during the period from 1978 to mid 1979, when G. William Miller was chairman of the Federal Reserve. In both the earlier period when Arthur Burns was chairman and the more recent period under Chairman Volcker, monthly percentage changes in the funds rate were significantly related to monthly deviations of money growth from target lagged from one-to-three months. Thus, the empirical results suggest that on average, the most recent period was more like the Burns period than the Miller period. The major difference between the Burns and Volcker periods is that, in the later, the funds rate moved almost 50% more in response to a given deviation of money growth from target.

While, *on average*, things may not be as different as they first appear, there have still been some striking changes since October 1979. For one thing, money growth has been much more volatile recently. For another, the relationship between discount-window borrowings and the funds-rate/discount-rate spread is notoriously imprecise and thus difficult to forecast in the short run. And, it has become even more volatile since the Fed changed operating targets. This is critical since under the current operating tactics, this relationship provides a major link between policy action and money growth. Finally, under the new tactics, it has become much more difficult to identify changes in Fed policy. Under the old operating procedures, it was fairly easy to tell when there had been a change in the funds-rate target simply by observing when the Fed intervened in the funds market. Today, however, it is difficult to tell from the behavior of reserves whether –or, equally as important, to what extent–the Fed has changed its policy stance.

When combined with the Fed's tendency to react more forcefully to the deviations from target of an inherently volatile money supply, these forces all have dramatically increased uncertainty over the interest-rate implications of current monetary policy. And this has continued to affect the financial markets adversely.

Thomas A. Lawler

F PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
of IMF it, mil- f dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	June 2, 1982		current monetary conditions	
5	Aid donors pledge $1.6 billion in new aid commitments.	March	+16%	Jan.	+ 4%	.0550	−12%	Bank borrowing for deficit financing to be near zero.	Bangladesh
5	Current-account deficit for fiscal year remained at about 6% of GDP.	Jan.	+ 2%	Apr.'81	+13%	.1319	− 9%	Kyat remains pegged to SDR.	Burma
8	Foreign trade ministry reorganized.	Dec.	+ 3%	Dec.	+19%	.5530	−15%	Money supply surged at the end of 1981.	China, People's Republic
–	Capital inflows increased since interest tax changes in February.	Oct.	+17%	Oct.	− 8%	.1736	− 5%	Money supply growth accelerates.	Hong Kong
7	Import restrictions liberalized significantly, particularly for productive inputs.	Feb.	+10%	Nov.	+13%	.1100	− 7%	Cash reserve ratio trimmed to ease credit situation.	India
0	Oil production has fallen below OPEC quota.	March	+10%	Dec.	+29%	.0015	− 6%	Rupiah slips against dollar.	Indonesia
0	Additional measures announced to alleviate trade frictions.	March	+ 3%	March	+ 9%	.004089	− 8%	Central bank supporting rates to help weak yen.	Japan
4	Growth of export letters-of-credit arrivals slows.	April	+ 9%	Feb.	+ 3%	.0015	0	Kerb market loan scandal depresses financial sector.	Korea
4	Crude oil prices reduced.	Jan.	+ 9%	Jan.	+11%	.4338	+ 2%	Government pledges tight control over money supply.	Malaysia
9	Policies enacted to spur exports, promote import substitution, curb luxuries.	March	+ 9%	Oct.	+14%	.0757	−13%	Foreign banks to be allowed to operate in Nepal.	Nepal
4	Growth of workers' remittances slows sharply.	Feb.	+10%	Feb.	+ 7%	.1000	− 2%	Modest reserve drawdown likely in fiscal year just ending.	Pakistan
9	First quarter current account gap more than doubled from year earlier.	Jan.	+18%	Feb.	+ 3%	.1230	− 8%	Central bank enters into deposit arrangement with Arab banks.	Philippines
0	Trade deficit increases, but reserves stand firm.	March	+ 8%	Jan.	+13%	.4763	+ 3%	Total bank asset growth stagnant.	Singapore
1	Additional food imports necessitated by poor crop outlook.	March	+13%	Feb.	+20%	.0500	−13%	Budget pressured by drought-related expenditures.	Sri Lanka
0	New Taiwan dollar drops marginally; exports slow.	Dec.	+18%	Dec.	+11%	.0258	−11%	Interest rates lowered.	Taiwan
5	Accord reached with EC limiting Thai tapioca exports.	March	+ 7%	Dec.	+ 2%	.0460	− 8%	Divestiture of finance companies proceeding slowly.	Thailand
0	Capital inflows revive to a record level in April.	Jan.	+11%	Feb.	+ 6%	1.0550	− 7%	Interest rates have risen.	Australia
7	Overall payments deficit for fiscal year ended March widened to NZ$1.14 bn.	Jan.	+16%	Feb.	+ 7%	.7585	−13%	Inflation-adjusted government bonds met strong demand.	New Zealand

World Interest Rates

market rates as of June 2, 1982; bond yields as of May 28, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	15.43	13.00 intervention rate	14.00	9.50	7.50	19.00 penalty rate 22.00	8.00	5.50	5.50
Day-to-Day Money	13.25 June 3	18 00	13.375	10.95	16.25	9.00	20.375	6.00	3.313 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	12.05 discount basis	15.60	12.625	15.00	n. a.	n. a.	18.952 85 days	no dealing	no market	5.625 two month
Commercial Paper prime, 3-month, asked	13.25 finance paper discount basis	16.00 finance paper 15% tax w/h	11.894	13.90 Certified	16.313 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.45	16.20 15% tax w/h	12.563	13.90 Certified	not traded	9.40	22.40	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	13.62	15.20	13.22	10.80 20% tax w/h	15.69	8.86	20.94	10.22	4.98	7.68
Industrial Bonds prime, long-term, new and old issues, average yield	14.95 Aa Industrials	15.50	14.60	14.737	16.74	9.00	20.79	11.08	6.025	6.67
Bank Short-Term Rate to Best Borrowers (prime rate)	16.50	17.00	14.00	17.50	18.05	12.50	21.75 ⅛ qtrly fee on outstdng.	10.50	9.50	6.00
Bank Time Deposits 3-month	13.625 Cert. of Dep.	16.00	13.00	14.65	16.313	8.90	11.50	8.75 large deposits	3.25 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	14.75	16.75	13.25	no market	28.75	8.75	no market	8.75	4.25	7.188
Exchange Rates—in U.S.$ rates floating against the $	—	0.803	1.793	0.023	0.162	0.423	0.001	0.379	0.497	0.004
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.949 *D*	1.772 *P*	1.932 *D*	12.951 *D*	6.304 *P*	9.511 *P*	6.255 *P*	10.672 *P*	7.970 *P*

Eurodollar Deposits
(London, interbank, bid)
June 3

7-day	14.125
1-month	14.4375
3-month	14.5625
6-month	14.625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.174
U.S.-Canada Treasury Bills	−0.811
U.S.-Canada Finance Co. Paper	−0.582
Eurodollars-U.K. Local Auth. Deposits	−0.147

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.00
Over 7 yrs.	15.00
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.125

Gold Price
London afternoon fixing
318.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	(April) 6.6	(March) 11.6	(April) 9.4	(April) 14.0	(May) 5.3	(May) 15.2	(April) 5.6	(April) 2.8
Industrial production*	(April) −7.4	(March) −10.4	(March) 0.4	(March) 0	(April) 0.8	(March) −1.5	n. a.	(April) 2.8
Trade balance† *(billions of local currency units)*	(April) −$0.32	(March) C$1.18	(Feb.) £0.17	(April) −FF10.25	(April) DM3.43	(March) −Lit.1,110	(April) −SF0.67	(April) ¥343
Money supply (M1)*	(April) 5.0	(April) 2.0	(March) 15.7	(Jan.) 16.0	(March) 2.8	(Jan.) 10.4	(Feb.) 6.0	(Feb.) 6.2
Velocity of money (M1)*	(March) −0.4	(Dec.) 17.7	(Dec.) −5.9	(Sept.) −3.6**	(Dec.) 7.1	(Dec.) 30.0**	n. a.	(Dec.) −5.2
Reserves minus gold *($ million, change from previous month)*	(April) 1,610	(April) 541	(April) 570	(Feb.) 163	(April) 763	(April) −1,877	(April) −59	(April) −272

* Percent change from 12 months earlier. ** based on GDP † Figures are only for the month indicated

Japan: In Need of a Domestic Recovery

Last year, Japanese economic growth slumped to 2.9%, a substantial drop from 1980's 4.2% and the lowest rate of real growth since 1975. Had it not been for exports, growth would have been lower still, since net external demand contributed nearly three fourths of the 1981 advance. This year, as continuing trade frictions and the world recession grind down the rate of export growth, the Japanese desperately need a revival of economic activity on the home front to bring the economy out of the doldrums. However, there is little in the 1982 outlook that suggests more than a modest recovery of domestic demand. And unless the government decides to sacrifice some of its long-run policy goals for short-run fiscal stimulus, Japan seems destined to suffer another year of sluggish economic growth.

Japan's domestic recession has already lasted far longer than most forecasters had expected. A rebound had been widely forecast for the second half of 1981. However, historically high real interest rates and the continued structural adjustment of certain key industries to the second oil price shock have kept domestic activity at depressed levels. In addition, the government's repeated rejection of a tax cut out of concern for the size of the budget deficit has acted as a further drag on spending and investment.

Consumer expenditures and residential housing investment were particularly weak last year. Although the spring negotiations resulted in union wage increases averaging 7.7%, workers on the whole averaged increases of only 5% because of the depressed business conditions suffered by small nonunionized firms. Owing to a decline in overtime and bonus payments, as well as to larger social security payments and higher taxes because of bracket creep, real disposable income showed little, if any, increase in 1981 despite a sharp drop in the rate of inflation. As a result, consumer spending, which, in Japan, accounts for over 50% of GNP, rose only 0.6% in real terms. Residential housing remained severely depressed not only because of the sluggish behavior of real income, but also because of a sharp increase in home prices and adverse demographic trends.

Private investment in plant and equipment by large companies remained firm throughout the year. However, investment by small enterprises—some 60% of total investment in Japan—lagged as a result of the high real interest rates and weakness in consumer spending.

Exports served as the economy's main source of strength. But even this support gave way in the final quarter, when net exports plunged at a seasonally adjusted annual rate of nearly 57%. This led to an annualized 3.5% drop in real GNP in the fourth quarter—the first quarterly decline in almost seven years.

Some of the domestic sectors, however, actually showed modest improvement toward the end of the year. Consumer spending and private business fixed investment, in the fourth quarter, grew at annualized rates of 2.2% and 5.6%, respectively—hardier growth rates than either had shown in more than a year. Still, a sharp increase in business inventories indicated that an unwanted inventory buildup had occurred as sales fell below expectations. This suggested that another period of inventory adjustment would be needed to bring stocks back down to desired levels. The recent behavior of Japan's industrial production index suggests that this process may be currently underway. But, since inventories still appear to be rising, the adjustment is likely to take a while longer to complete.

Growth outlook for the rest of 1982

Although clearer-cut signs of an economic revival are expected to emerge later in the year, the current outlook suggests that 1982 will still show only lackluster growth. With trade pressures continuing, growth of Japan's external markets is likely to be moderate, even if exports pick up as the world recovery takes hold. Thus, any economic rebound for Japan will have to draw its major momentum from domestic demand.

An increase in consumer spending will be critical and is forecast. However, it is likely to be far from robust. Real consumption expenditures have been on the rise in 1982, according to recent data. Moreover, this spring's labor negotiations appear to have resulted in average wage increases of about 7%. While average overall wage increases may once again be somewhat less, the continued low rate of inflation and stepped up overtime and bonus payments as business activity recovers are expected to boost real disposable income and consumer spending. Nevertheless, any increase is likely to be modest because of the continued tax drag. Thus far, the Japanese government—still firm in its commitment to reduce its budget deficit—has given no indication that it is moving toward a tax cut.

Other sectors of the economy appear equally incapable of generating a strong rebound this year. Private plant and equipment investment by small businesses may pick up as consumer spending revives somewhat, but investment by large firms is expected to slow. Furthermore, residential housing is unlikely to show any substantial recovery from last year's depressed level owing to continued unfavorable price and demographic trends. Thus, for the year as a whole, real growth is expected to be a sluggish 2.1%—considerably weaker than many forecasters had projected earlier this year.

In addition, inflation could begin to accelerate by the end of 1982. Inflation improved dramatically in 1981—consumer prices rose just 4.9% on average compared with an average increase of 8% in 1980. And for 1982 as a whole, consumer price inflation is expected to average

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just 3%-3.5%. However, the relatively expansionary monetary policy that the Bank of Japan has been pursuing could begin to put upward pressure on prices by the year's end.

Continued trade tensions

Despite a marked slowdown in exports over the past several months, and recent steps to liberalize import restrictions, trade pressures on the Japanese are likely to remain intense.

The Japanese recorded a trade surplus of over $20 billion last year--the second largest surplus ever. Exports increased 17.9% in value and some 10.5% in volume, in spite of attempts to restrain exports, because of the strong non-price competitiveness of Japanese products and the weakness of domestic demand. At the same time, imports rose just 3.8% in value and actually fell 2% in volume terms, owing to the domestic weakness. Raw materials imports declined in volume because of the depression in Japan's basic materials industries and crude oil imports in particular dropped 10.6%.

With such a large increase in its trade surplus, Japan's current account registered a sharp turnaround to a surplus of $4.7 billion from a deficit of $10.8 billion in 1980. This was more than offset, however, by a $7.2 billion outflow of capital, attributable to Japan's relatively expansionary monetary policy. An excess supply of yen was reflected in lower real interest rates in Japan than in the United States. And as investors responded to the higher rates abroad, the inflow of capital to Japan slowed and capital outflow surged. As a result, the overall balance of payments was in deficit by $2.1 billion, and the exchange rate remained relatively weak, averaging 220.53 yen per dollar for the year.

In response to the persistent weakness of the world economy and increasing trade restrictions, Japan's exports have slowed dramatically in recent months. Except for January, which was a special case due to the bunching of exports of ships, exports on a seasonally adjusted basis have declined steadily since November and have been well below comparable levels of a year earlier. At present, export letters of credit fail to indicate a pick up anytime soon, despite the weak yen. And even as imports have remained depressed, the slowdown in exports has cut the seasonally adjusted quarterly current-account surplus to around $1 billion in the final quarter of 1981 and in 1982's first quarter—down from more than $2 billion in the third quarter of 1981.

Even with the striking slowdown in exports, Japan's 1982 trade surplus is projected to expand beyond that of 1981. Exports are expected to accelerate later in the year as recovery gets under way in Europe and the United States. However, growth will be more moderate than last year because of continued protectionist pressures. Imports, on the other hand, may start to pick up a little in the coming months, but on the whole are expected to remain extremely sluggish. Despite recent moves to encourage imports, the structural depression in the basic materials industry, combined with continued energy conservation and the decline of world oil prices, will work to keep the value of total imports low. As a result, Japan's trade surplus is expected to widen to $23.2 billion—a figure that may heighten the ire of its trading partners.

With the expanded trade surplus, the surplus of the current account is expected to rise slightly to around $6.3 billion. Nevertheless, if the Bank of Japan continues to follow a relatively expansionary monetary policy, the overall payments balance can be expected to remain in the red and the yen-dollar exchange rate is likely to average a weak 225-230 for the year.

Policy pressures

Concern that a weak yen could increase the trade surplus even further and thereby worsen trade frictions has apparently prompted some second thoughts about Japanese monetary policy. The monetary authorities have taken selective action in recent months in an attempt to directly control capital outflows and ease the downward pressure on the yen. In addition, the Bank of Japan has been intervening heavily in the domestic money markets to guide short-term interest rates higher or to at least prevent them from falling during the April-June seasonal surplus of funds. In fact, there is some evidence that the monetary authorities may have actually tightened somewhat during the process, pushing short-term interest rates back to the level they were at before last December's discount-rate cut.

Still, however, the outlook for the domestic economy over the next several months remains dismal. And with stimulative fiscal measures essentially precluded by the government's commitment to reduce the deficit, policymakers currently have limited means with which to spur domestic demand. Thus, monetary authorities are expected to maintain a reasonably expansionary monetary policy for a while longer. If, however, this stance results in a depletion of reserves and an acceleration of domestic inflation, the authorities could act to tighten significantly toward the end of the year.

In the event that the domestic economy fails to pick up, the government undoubtedly will be forced to reconsider its fiscal policy stance—including its position on tax cuts. Already, a supplementary budget is expected to be submitted later in the year calling for additional public works funds. And unless the economy bounces back stronger than is currently expected, another large revenue shortfall seems inevitable. This could force the government to finally abandon its goal of balancing the budget by fiscal 1985. *Melanie L. Lau*